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The Future of Company Taxation in the European Union

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THE FUTURE OF COMPANY TAXATION

IN THE EUROPEAN UNION

Comments by Professor Peter Birch Sørensen
on the speech given by EU Tax Commissioner Frits Bolkestein
at the conference on 'Tax Policy in the European Union'
in Rotterdam, 18 October 2001

It is exciting that we are gathered for this conference just as the European Commission is about to publish its long-awaited study on the future of company taxation in the EU. I am sure we all appreciate that Commissioner Bolkestein gives us this opportunity to learn about the contents of the new report.

Before I turn to the issue of company taxation, let me say that the Commissioner is undoubtedly well in line with academic opinion and sentiments in Member States when he says that there is no need for harmonisation of personal income taxes within the European Union. I also agree with the Commissioner that there is indeed a need for some coordination of capital income taxes. It is encouraging to note the Commissioner's confidence that Member States will not hesitate to adopt the proposed 'Savings' Directive which aims at improved exchange of information to ensure effective taxation of foreign interest income. Adoption of this Directive should raise economic efficiency by securing equal tax treatment of foreign-source and domestic-source income from savings. But more importantly, effective enforcement of taxes on foreign savings income will stengthen the legitimacy of the European tax order by demonstrating to the ordinary voter that the liberalization of capital flows within our Community was not carried out in order to facilitate tax evasion, but in order to raise the productivity of the European economy.

The most interesting part of Commissioner Bolkestein's speech dealt with the new Commission report on company taxation. According to the Commissioner the new study reveals substantial variation in effective corporate tax rates across Member States. It also shows that most of this variation can be traced to differences in statutory corporate tax rates. Despite this finding the

Commissioner seems very much opposed to a harmonisation of corporate tax rates, whereas he appears to be more positive towards some kind of harmonisation of the corporate tax base. In the rest of this comment, I will concentrate on this issue of company taxation in Europe.

The basic issue is: should corporation taxes be harmonised at all? And if so, how far should harmonisation go? At the moment, multinationals have to deal with 15 different company tax systems within the EU, and their choice of investment location within the Union can have very important tax implications. There is considerable evidence from academic research that these tax differentials affect corporate location decisions, even though taxes are of course only one of several factors determining the choice of location. To my mind, the large variation in the tax treatment of corporations is incompatible with the idea of a single market offering a level playing field for business competition. Because the level of corporation tax depends on the location of investment - and not on the shareholders' place of residence - the existing corporate tax differentials imply that corporate capital may flow to the countries offering the lowest effective tax rates, and not to the countries where capital can be most productively employed.

The Commissioner mentioned four different blueprints for comprehensive company tax reform aimed at removing tax obstacles to the efficient functioning of the Single Market: 1) Home State Taxation, 2) A Consolidated Common Tax Base, 3) A European Union Corporate Income Tax administered at the EU level, and 4) A Compulsory Harmonised Tax Base. The first three systems would be an optional choice for EU multinational companies, whereas the fourth system would be mandatory for all corporations in the Union, including those with only domestic operations. These ideas for company tax reform have already been discussed in the European tax policy debate for a while, and this enables me to offer some comments on them.

A common feature of the four systems mentioned above is that they all eliminate the current practice of separate accounting based on the arm's length principle for individual entities within a mulitinational group. Instead, European multinationals will be allowed or required to calculate their EU-wide profits under a single, consolidated tax base. As a substitute for separate accounting, a common formula would then be used to apportion profits to Member States for taxation. All four systems assume that Member States will maintain their right to choose their own tax rate on their apportioned share of the EU-wide profits of a multinational group of companies.

It is highly interesting that the well-known problems of transfer pricing and thin capitalization under separate accounting have now motivated the Commission to seriously consider the alternative of formula apportionment which has long been advocated by many academics. The use of formula apportionment raises a number of difficult issues such as the problems of defining a group of related companies to be subject to formula apportionment; specifying the factors in the formula, and separating the EU tax base from corporate income from non-EU sources. This is not the place to discuss such technical issues. Let me just briefly state the main advantages and disadvantages of the four different company tax systems, as I see them:

The system of *Home State Taxation* implies that EU multinationals would be allowed to calculate the consolidated profits on their EU-wide activities according to the tax code of their Home State, that is, the Member State where their headquarters are located. A German-based multinational would calculate its EU profits on the basis of German tax rules; a multinational group headquartered in France would calculate its total taxable EU-wide profits in accordance with French tax law, etc. From the perspective of national policy makers, the main advantage of Home State Taxation is that it does not require any harmonisation. All that is needed is that participating Member States mutually recognize the company tax systems of the other countries participating in the system. For tax administrators the elimination of separate accounting should make life easier by eliminating the need to enforce complex transfer pricing rules for transactions within the EU. From the perspective of the business community, one attractive feature of Home State Taxation is that the system is optional: no company will be forced to switch to the system, but those that make the switch are likely to experience lower tax compliance costs, since they will no longer have to adhere to the different and sometimes conflicting national rules for the setting of transfer prices. Switching to a consolidated tax base will also enable companies to offset losses on operations in one Member State against profits made in another Member State, and corporate restructuring within a consolidated group will meet with fewer tax obstacles.

At the same time the attractive flexibility of Home State Taxation is also the main weakness of the system, since the existing differences across national tax systems will continue to create distortions. Apart from the fact that national differences in statutory corporate tax rates will remain, members of different multinational groups operating in any given EU country will be subject to different tax base rules if their parent companies are headquartered in different Member States. Further, and perhaps more important, Home State Taxation will invite Member States to compete by offering generous tax base rules in order to attract corporate headqarters. Such competition would create negative revenue spillovers, since a more narrow tax base definition in any given Home State would apply not only to income from activity in the Home State, but to income earned throughout the EU area. Hence it is very difficult to imagine that Home State Taxation could be viable in the long run if the system is not complemented by some common minimum rules regarding the acceptable definition of the tax base.

In contrast to Home State Taxation, the *Consolidated Common Tax Base* acknowledges the need for a harmonised set of rules defining the tax base for those companies opting for consolidation of their EU-wide profits. This will eliminate tax base competition for corporate headquarters and will create a more level playing field for European multinationals. Of course, the price to be paid for these advantages is the loss of national autonomy implied by tax base harmonisation. Moreover, the fact that the harmonised base would apply only to multinationals could create distortions between large and small firms operating within each Member State, since the small firms without international operations would still be subject to the domestic tax rules. It would also be a clear disadvantage that each national tax administration would have to deal with two different tax systems, that is, the new Consolidated Common Tax Base applying to multinationals, and the existing national tax rules relevant for domestic firms.

The same comments apply to the *European Union Company Tax* which is economically equivalent to the Consolidated Common Tax Base except that the latter system is supposed to be administered by national governments, whereas the European Union Company Tax is supposed to be administered at the EU level, with some or all of the revenue accruing directly to the EU.

I propose that comprehensive company tax reform in the EU should be guided by two basic principles: First, tax administration and tax compliance should be simplified for *all* the parties involved, that is for governments as well as for companies. Secondly, company tax reform should strive to create a level playing field for *all* firms, domestic as well as international. On the basis of these two principles, I prefer the fourth alternative in the Commission report, the so-called *Compulsory Harmonised Corporation Tax*. This system implies that a single corporate tax base would apply for all firms in all member states. Indeed, I would go even further and argue for a harmonised corporate tax rate as well.

In matters of EU tax coordination, the challenge is to strike a balance between the desire to create a smoothly functioning internal market - which tends to call for tax harmonisation - and the desire of Member States to preserve a reasonable degree of national autonomy in tax policy. I suggest that a fair compromise between these legitimate goals could consist of a fully harmonised corporation tax *combined with* effective exchange of information enabling EU Member States to enforce residence-based personal taxes on income from capital, as intended by the proposed Savings Directive. A fully harmonised corporate tax base would secure all of the gains from tax base consolidation mentioned above. Rate harmonisation seems justified by the finding of the Commission study that the bulk of the cross-country variation in effective corporate tax rates is caused by the current variation in statutory tax rates. A harmonised corporation tax with a consolidated tax base would of course require formula apportionment of corporate tax revenues across Member States.

In the current era of euro-scepticism it may seem quite radical to propose a harmonisation of the rates as well as the base of corporation tax. However, it is crucial to keep in mind that the distribution of the tax burden across taxpayers depends on the *total* tax burden on income from capital. Apart from the corporation tax, this burden also includes personal taxes on income and wealth. An effective exchange of information among national tax administrations within the EU would improve the ability of Member States to enforce personal taxes on the interest and dividends paid out by the corporate sector, as well as personal taxes on capital gains on shares. In the current regime with hardly any exchange of information, the potential for capital flight to foreign bank accounts which cannot be monitored seriously constrains the ability of individual Member States to impose taxes on income from mobile portfolio capital. By improving the ability of governments to tax foreign source income, information exchange will *strengthen* national tax autonomy, making it easier for each Member State to choose its own preferred level of personal taxes on capital income. If they obtain more room of maneuver in the field of personal income taxation, EU Member States should be more willing to give up autonomy in the area of corporate taxation to eliminate the many distortions to the Single Market created by the current corporate tax differentials.

The point is that the corporation tax is really just a withholding tax, serving as a prepayment of the final taxes on the capital income originating from the corporate sector. The final tax burden is determined by the personal taxes levied on interest, dividends and capital gains, and these taxes will remain under the control of Member State governments even if the corporation tax were harmonised. If a Member State finds that the harmonised corporation tax implies an inappropriately low level of tax on corporate-source equity income, it can rectify the situation by adding personal taxes on dividends and capital gains at the shareholder level. If it finds that the harmonised corporation tax is too high, it can use part of its apportioned corporate tax revenue to finance tax credits to shareholders.

It might be objected that since the corporation tax serves as a ’backstop’ for the personal income tax, ensuring that shareholders cannot accumulate funds within the corporate sector free of tax, countries with relatively high levels of personal income tax will also want to impose relatively high levels of corporation tax, and vice versa. However, in practice there is no systematic link between corporate and personal tax rates in the EU. For example, Denmark imposes a top marginal personal income tax rate of almost 60 percent, but her corporate tax rate is only 30 percent. By contrast, Italy has a corporate tax rate of 37 percent, even though she only levies a top personal tax rate of 46 percent. Hence the ’backstop’ function of the corporation tax is hardly a serious argument against EU corporate tax harmonisation. This conclusion is strengthened once one considers that governments can supplement the corporation tax on retained earnings by a personal tax on capital gains on shares.

A more serious objection to my suggested combination of corporate tax harmonisation and residence-based personal taxation determined by Member States is that residence-based taxes may be undermined by the possibility of capital flight from the EU area if important third countries refuse to cooperate on information exchange. This is indeed a serious concern, although the OECD is making sustained efforts to induce the tax havens of the world to adopt a more cooperative attitude. We have reason to hope that the tragic events of September 11 this year will pave the way for more international cooperation. Gradually it will become clear to a critical mass of countries that the rules of bank secrecy enacted many years ago under very different historical circumstances are no longer appropriate, if we want to ensure a safe and stable environment for legal transactions by households and firms in today’s globalized economy.

Let me come to my conclusion: the new Commission report on company taxation will give a welcome boost to the European tax policy debate. As Commissioner Bolkestein has indicated, the report contains pragmatic proposals for piecemeal reforms aimed at the short run, and more ambitious reform options for the longer run. As I have tried to make clear, I believe that full corporate tax harmonisation is still a legitimate long term goal for EU tax policy and will become more pressing as economic integration deepens.

Nevertheless, it makes sense to proceed in steps. A harmonisation of corporate tax rates is a highly visible and hence rather controversial form of tax coordination. For the short and medium run, it may be better to focus on a reduction of the costs of tax compliance and tax administration via a harmonisation of the corporate tax base. Once this is achieved, the process of tax competition via statutory corporate tax rates will become more transparent. Member States imposing aggressively low statutory rates will no longer be able to claim that the higher rates levied by other countries are offset by special provisions and deductions etc. The greater transparency in tax competition is likely to create more political pressure for a floor to corporate tax rates, as it becomes clear that corporate tax competition is essentially a zero sum game. Hence the next step could be the adoption by Member States of a binding minimum statutory corporate tax rate, applied to the common base. In parallel, the EU will hopefully be able to gradually establish an effective exchange of information among tax authorities, supported by cooperation with important third countries, as intended by the Savings Directive. If we can achieve this, the improved enforcement of residence-based taxation and the resulting strengthening of national tax autonomy will justify the third and final step which would be a complete harmonisation of the corporate income tax, in accordance with the logic of the Single Market.

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